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Monthly Letter on
Economic Conditions
Government Finance

1949

New York, March, 1949

General Business Conditions

THE past month has brought little change in the state of business, which is mostly slow as compared with a few months back, or in general sentiment, which continues cautious. In some cases order books have been built up during a period of curtailment, or seasonal expansion is occurring, and workers previously laid off have been rehired. However, new layoffs also have been reported. The number of people on the unemployment compensation rolls has continued to rise. Trade has been sluggish, with department store sales during February running below a year ago.

The fact which dominates current conditions is that people and business alike are spending less freely. Some people have been priced out of the market because inflation made things too expensive to buy, some have had declines in dollar income, some have contracted all the debt they want to carry, and some think the time has come to increase their savings. All have bought heavily during the past two or three years and no longer need things as urgently, and many now think they will get lower prices or better quality by waiting. Among business men the influences are much the same, plus the fear of inventory loss as prices decline. The common policy is to shorten stocks and keep commitments down. The resulting drop in orders is multiplied as it works its way back to the primary industries.

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Curtailment Moderate

In overall industrial production, curtailment has not proceeded far. The coal markets have been slow, and operations have been cut moderately in bituminous and sharply in anthracite. Petroleum output has been reduced. Lumber production is down. Brass mills are on short time. The textile and shoe industries are curtailed. Moreover, the real feature of the winter's news is that cutbacks similar to that which began in cotton goods a year ago have now spread to household equipment items and other durable goods. But even with the slowing down in these areas, the Federal Reserve Board's index of industrial production, which in October stood at the peacetime record of 195 (1935-39 = 100), in January was still 191.

Apparently the February rate has continued close to that figure. Overall activity is supported by record-breaking steel output. Automobile assemblies are high and are scheduled to move higher. Many other industries, including utility and railroad equipment, most of the machinery and chemical groups and food products, continue to operate almost at peak rates.

Despite the increase in unemployment more people were at work in January than a year earlier, 57.4 million against 57.1, according to the Census Bureau. Personal incomes have been running well above a year ago. Latest estimates issued by the Department of Commerce were for December, when total personal income was

at the seasonally adjusted annual rate of $220.8 billion and disposable income $200.5 billion. Both figures represented new all-time peaks and compare with $207.7 and $185.1, respectively, a year earlier.

Probably employment has dropped since the January figures were compiled, but it is unlikely that income totals have declined much. Unemployment compensation and other welfare benefits help maintain personal income, and the Department of Agriculture is authority for the statement that farmers' cash receipts have not suffered from the decline in farm prices as much as people may think. The department says farmers' cash income in February was possibly 10 per cent higher than a year ago, owing to larger sales of livestock and corn. January cash income was lower than last year, but on this showing the total for the first two months has been up a little.

With people still receiving record-breaking incomes, the present slackening evidently is not due fundamentally to shrinkage of buying power. It seems more correct to say that the main cause is the filling up of pipelines and what may turn out to be the end of voluntary inventory accumulation, which has augmented current demand for the past several years. Other causes are the uneven effects of inflation, which has priced people with lagging incomes out of the market, and the psychological influences diminishing the will to spend. Not only are the most urgent wants satisfied, but expectation of lower prices is widespread.

Seasonal Influences

Any examination of the causes of the slackening should also recognize two influences which will soon turn the other way. One is the reappearance in some industries of seasonal trends, which had disappeared during the inflation. Midwinter slackness, notably in lines connected directly or indirectly with outdoor work, is common in normal times. Similarly, a "Spring rise" is expected unless conditions are generally unfavorable. In a short time the influences which normally bring such a rise will be operating again.

The second influence is also seasonal in character, namely, the fluctuations of the Federal Government's receipts and expenditures. During the first quarter of 1949 the Treasury may have a cash surplus of $4 billion, reflecting the January 15 and March 15 income tax collections and the unusual amounts of social security taxes and withheld income taxes transmitted in February. In essence, the Treasury during these three months is taking away from people and business perhaps $4 billion more than it is paying out to them. This surplus, however, will not continue. Chairman McCabe of the Federal Reserve Board and many others have pointed out that, with rising expenditures, the Treasury will have a cash deficit for the last nine months of 1949; it will pay out to people more than it takes from them.

Whether business fluctuations are much influenced by such variations in the Treasury's position can hardly be proved one way or the other, but the softening under similar conditions both in early 1947 and early 1948, and the subsequent recoveries, give support to the possibility. In any case, this and other seasonal influences will within a few weeks swing over to the favorable side.

With an eye on these influences, hopes of a coming improvement in sentiment and a more stable situation are entertained by a good many observers, including members of the President's Council of Economic Advisers and others in the Administration. From this point of view April will be a significant month. If employment fails to show a vigorous rise and trade and markets register no improvement, the disappointment is likely to produce a fresh wave of hesitation and slackening.

The Fundamental Factors

The question of first importance, however, is not whether seasonal improvement will or will not show, but what is the fundamental situation. The dangers, if a cumulative weakening of sentiment should set in, are apparent. The people of this country enjoy a standard of living farther above a subsistence level than those of any other country in the world. By the same token more of their wants are postponable. Uncertainty and caution are contagious. The psychological element will influence all who are making up their minds whether to run the old automobile or the old refrigerator another year. It will influence business decisions not only in current buying but in plant and investment expenditures. These are vital matters in the outlook.

Moreover, everyone recognizes that the long inflationary rise leaves maladjustments in the situation. Some prices have to come down, and some stocks of goods have to be worked off. Some people, who lack capital, ability, or experience to make a success of business except in times of inflated demand and sellers' markets, will have to make way for more efficient competitors.

On the other hand, there are also virtual certainties on which observers agree, and which

argue against the development of a downward spiral. One is that the Government will be spending more, which is a counter to private deflation. Another is that an important segment of business investment, such as the utility program, and of construction, including state and local government institutions, highways and the like, will go ahead under any conditions because the need will not permit deferment. Still another is that the ECA program assures the country of an export surplus. Farm price supports, stockpiling of nonferrous metals and other strategic materials, unemployment compensation, and an easy money policy are all cushions supporting the economy during an adjustment period. Financially, the economy is strong and liquid. Not only is current income backed by an unprecedented volume of liquid assets, but there is no such structure of private debt and no such evidence of financial strain as has preceded past periods of general and severe liquidation. These are matters to which these Letters have often referred, and to which we recur because they seem fundamental.

Readjustments Under Way

Finally, the economic adjustments which experienced people have recognized to be necessary are making progress. It is not correct to think that all business and all prices rose concurrently to a uniform climax last September or October and that all are now suddenly faced with the need to retrace their steps. On the contrary, adjustments were under way in some cases long before the overall indexes reached their peak. In cotton goods the top of prices and market activity was reached at the beginning of 1948. The price decline since then has been nearly 50 per cent in some constructions, and 30 or 35 per cent in a good many. From January 1948 to January 1949 the mill consumption of raw cotton dropped 22 per cent. This is a considerable adjustment.

Department store buyers have been shortening commitments. At the end of 1948, according to figures collected from 296 stores by the Federal Reserve Board, outstanding orders for merchandise were 46 per cent below a year ago, and although stocks were 6 per cent higher, stocks plus orders were lower by 15 per cent. So far in 1949 buyers have been equally conservative. This also is a considerable adjustment.

Other industries which sometime ago, in varying degrees, experienced a decline and cut their cloth accordingly include glass containers, tires, amusements, furs, jewelry, beverages, cosmetics, shoes and leather goods, radios and fractional horse-power motors. Aircraft and shipbuilding have come through postwar adjustments to better times. In other cases the pipelines have filled up more recently, and the shock of change is relatively new. Nevertheless, belief that all the trouble is still ahead and nothing behind oversimplifies the situation.

The decline in farm prices is also an adjustment, and a considerable one, toward a better balanced price structure. It reduces farmers' income and may also reduce the incomes of people selling to the farmers. But it will increase the real buying power of many people whose incomes will not be affected, including in general the large group of fixed income recipients and white collar workers who have been the real victims of inflation. Most important of all, through its effects in turning the cost of living trend downward, it lifts the basic pressure which has been the driving force of the wage-price spiral.

Washington Expects Inflation

Whatever their own opinions of the outlook, business men are almost unanimous in rejecting the views which seem to predominate in Washington. According to various members of the Cabinet, the Council of Economic Advisers and other government agencies, the country is still in an inflation crisis, a new upsurge of prices is likely, and the Government should have new powers to deal with it. Mr. John D. Clark, member of the Council of Economic Advisers, argues the official case by expressing his doubts that the increase in unemployment has been more than seasonal, and by predicting that the rise in agricultural employment in April, together with higher government expenditures, will start inflation rolling again. Mr. Leon H. Keyserling, Vice Chairman of the Council, says that "some very important prices at some very vital spots in the economy have not been leveling off, but instead have continued to rise at an accelerated rate, are now at their all-time peaks, and threaten to rise still further." He adds that we cannot be sure the cost of living will not go up again.

To most business men the spectacle of filled up pipelines, increasing food supplies, declining prices, receding plant and equipment expenditures, and demand falling below productive capacity in one line after another, seems to be an obvious and sufficient answer to the fears of Messrs. Keyserling and Clark. The danger in the matter is not that the latter may make wrong prophecies, but that wrong policies may be founded upon them. Memories go back to the Fall of 1945, when Washington prophets ex-

pected postwar unemployment of 8 million people, a $20 billion drop in national income and other deflationary developments which never transpired. Business men familiar with the problems of postwar transition were convinced that the 1945 prophecies were incorrect, as time proved them to be. The question now is whether the 1949 prophets are any better.

The consequences of the 1945 mistake were the establishment of inflationary policies, notably through government intervention in the wage negotiations of the time and the establishment of a pattern of wage increases which industry will always believe to have been excessive, and which started the wage-price spiral. The question now is whether an equally mistaken diagnosis will result in an equally ill-timed adoption of deflationary measures. The effect of tax increases, and granting to the President the various new powers desired by him, would be deflationary in the present situation. They would also be deflationary even if the seasonal improvement expected by Mr. Clark should develop. Nothing could be more calculated to bring such improvement to a speedy end. The possibility of such measures stands high among current reasons for apprehension.

New Government Powers Asked

Moreover, the issues are far deeper than would be involved in a merely transient mistake. In the three-part "Economic Stability Act of 1949" the Administration is asking for a series of far-reaching powers over the economic organization, including (among others) authority to enforce mandatory priorities and allocations; to require notice of intended price increases; to establish maximum prices; to exercise control over wage increases; and to bring about increases in industrial capacity through government loans and if necessary government construction, after study has determined the need for such increase.

Mr. Keyserling, indeed, would make the government responsible for the state of business at all times. He said in his testimony before the Joint Committee of Congress on the Economic Report, February 8:

> . . . In a period of high prosperity such as we now enjoy, the economy contains a mixture of trends. Some prices are too high and rising too fast and some activities are too hectic, and these have an inflationary cast. Other prices may be too low or falling too rapidly and some activities are softening too much or not expanding rapidly enough, and this has a deflationary cast. The problem is at one and the same time to prevent either the inflationary cast or the deflationary cast from becoming so pronounced and so prominent that the whole economy becomes seriously affected.
>
> For these reasons, we need a discriminating and selective combination of policies, to deal with the inflationary cast and deflationary cast at the same time . . .

In other words, in Mr. Keyserling's view, the Government should not only set its policies with reference to general trends. It should decide which prices are too high and which too low, which industries are too active and which not active enough. It should take specific steps accordingly.

This doctrine goes a long way beyond any conception of the function of government that the American people have ever been willing to accept. It would throttle the price system and bring the practical decisions of business under an unprecedented degree of government control, with little or no regard for the consequences in the way of destruction of independence, incentive and enterprise and the impairment of the productive organization. The fundamental error in the doctrine is that it vastly exaggerates the power and capability of the government to stabilize and direct business, and imposes a greater degree of responsibility than the government can properly assume or competently exercise. A few questions are pertinent. Who are the all-wise controllers that are to be entrusted with these powers? Will they be free of political interference? What analytical and forecasting methods can they rely upon? What economic doctrine and theory will they follow?

Corporate Earnings Trends

Annual reports for 1948 already issued by over 2,100 leading American corporations indicate an increase to new all-time high records in the overall totals of sales, payrolls, net income, dividend payments, and expenditures on new plant and equipment. Our tabulation of earnings now in progress, which will be summarized by 70 major industrial groups in our April issue, shows that the combined net income given in reports issued to date increased from approximately $5,925 million in 1947 to $7,118 million in 1948, or by 20 per cent.

Lower earnings were shown by about 35 per cent of all reporting companies and by the group totals in a number of important industries. Such decreases were sharpest among those companies which experienced a falling off in sales volume last year, counter to the general trend, and were unable to maintain profit margins by reducing costs correspondingly. With the marked changes this year in sales, prices, and competition in many lines, business men are acutely conscious that the record 1948 net income of many companies is very much "water over the dam" and is no reli-

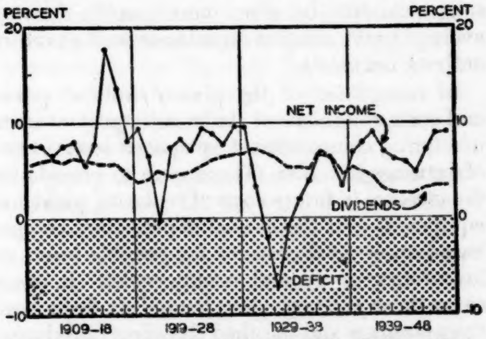
able indication of current earnings or probable results for the full year 1949.

The average profit margin in 1948, computed for all companies publishing sales or gross income figures, which aggregated over $89 billion and represented over four-fifths of the total number of reporting companies excluding the finance groups, was 6.5 cents per sales dollar, compared with 6.3 cents in 1947. In other words, higher dollar earnings were mainly a reflection of the greatly expanded volume of goods and services sold rather than larger profits per unit of sales.

The book net assets of all reporting companies, based on the excess of total balance sheet assets over liabilities and represented by outstanding capital stock and surplus accounts, aggregated $57.0 billion at the beginning of 1948, upon which the year's net income was at the rate of 12.5 per cent, compared with net assets of $53.1 billion in 1947 and a return of 11.2 per cent. The plant and equipment assets, generally carried on the books for accounting purposes at original costs less accrued depreciation, are of course far below present-day costs and hence greatly understated relative to the present purchasing power of the dollar. Also, the amount of the book net assets in many instances has been reduced through the elimination of intangibles, goodwill, etc., and through reorganizations, recapitalizations, etc. Therefore the rate of return computed upon such book valuation is much higher than that actually earned on the basis of current replacement costs of assets or on the capital which was actually invested in the business.

A preliminary summary of the totals by major divisions is given in the accompanying table. Although many of the largest corporations in their respective industries have not yet reported, the figures already available comprise about one-third of the net assets of all American corporations.

As shown by the accompanying long-term diagram, based on Department of Commerce figures, the percentage of estimated net income after taxes of all corporations to national income in 1948 does not appear to have been abnormally high for periods of general prosperity. The ratio of corporate dividends paid to shareholders to the national income, on the other hand, was near the lowest for any year of the entire 42-year record.



Percentages of Corporate Net Income After Taxes, and of Corporate Dividends Paid, to Total National Income.

Earnings of Manufacturing Companies

For the 1,035 companies that have reported to date in the manufacturing industries, which comprise a major portion of the grand total for all lines, the combined net income last year was 20 per cent greater than in 1947, accompanying a 15 per cent increase in dollar volume of sales. This increase in the net income total occurred although only 57 per cent of the reporting companies had increases, against 43 per cent with decreases. About 6 per cent had actual deficits, even in a year regarded as so generally prosperous.

Groups showing the largest increases in net income, as well as in sales, included petroleum, iron and steel, automobiles and trucks, aircraft, machinery, agricultural implements, household appliances, cement and other building materials,

Preliminary Summary of Net Income of Leading Corporations for the Years 1947 and 1948

(In Millions of Dollars)

No. of Cos.	Industrial Divisions	Reported Net Income After Taxes 1947	1948	% Change 1947-1948	Book Net Assets Jan. 1 -a 1947	1948	% Return on Net Assets -a 1947	1948	% Margin on Sales -b 1947	1948
1,035	Manufacturing	$3,791	$4,555	+20	$22,006	$24,598	17.2	18.5	6.5	6.5
59	Mining, quarrying	111*	159*	+43	782	836	14.2*	19.0*	11.8*	12.6*
122	Trade	338	362	+ 7	2,075	2,278	16.3	15.9	3.3	3.2
180	Transportation	525	730	+39	13,023	13,419	4.0	5.4	5.6	7.2
122	Public utilities	509	584	+15	6,840	7,115	7.4	8.2	10.5	10.6
72	Amusements, services	86	61	—29	604	641	14.2	9.5	6.9	4.0
583	Finance	567	668	+18	7,757	8,122	7.3	8.2	—	—
2,123	Total	$5,925	$7,118	+20	$53,086	$57,010	11.2	12.5	6.3	6.5

a—Net assets at the beginning of each year are based upon the excess of total balance sheet assets over liabilities; the amounts at which assets are carried on the books are far below present-day values. b—Profit margins computed for all companies publishing sales or gross income figures, which represent over four-fifths of total number of reporting companies, excluding the finance groups; includes income from investments and other sources as well as from sales. *—Before depletion charges in some cases.

and chemical products. In a number of other groups where supply was catching up with demand and sales expansion was tapering off while costs still increased, earnings of many leading companies were substantially lower. This was evident in numerous branches of food products, beverages, textiles and apparel, pulp and paper products, leather tanning and shoes, tires and other rubber goods, and paints. Our detailed summary classified by forty-five manufacturing subgroups will be given next month, showing average profit margins on sales as well as return on book net assets.

In recognition of the present inflated prices and costs, a number of the more important manufacturing companies set up special reserves out of earnings last year. These were to provide for the increase in future costs of replacing plant and equipment over the normal depreciation charges based on original costs, or for possible losses on inventories or general contingencies. In some cases these reserves were treated as deductions from earnings and thus had the effect of reducing the reported net income. In others they were treated as appropriations of reported net income – representing surplus earmarked to be retained for specific or general purposes. For most companies, however, no special provision was made for these purposes.

Effects of Sales Declines on Earnings

During the past few years of high level business activity, combined with rising costs which have tended to lift industrial "break-even points," there has been much speculation as to how vulnerable earnings might prove to be to any subsidence of the abnormal business volume. Undoubtedly apprehensions on this score have been a factor in the much commented on failure of stock market prices to reflect high earnings more fully. Now that instances of sales decline are beginning to crop up more frequently, it is becoming possible to make comparisons with earnings declines in such cases.

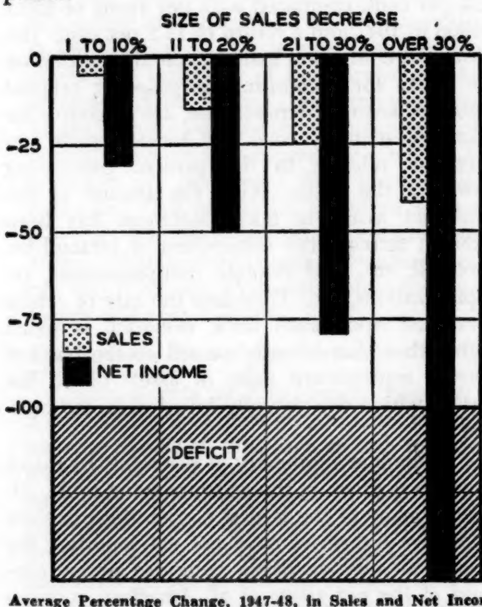
Among the manufacturing companies which have published both sales and earnings figures for 1948 were 185, or about one out of five, whose sales declined. For this important minority of companies, the scissors-like effect upon net earnings of a recession in sales volume combined with high or rising costs is indicated by the following table and diagram.

It will be seen that the changes ranged from an average decline of 28 per cent in net income for the group with sales decreases of 1 to 10 per cent, to a net deficit for the group with sales decreases of over 30 per cent. For the group as a whole an average decline of 14 per cent in sales was accompanied by an average drop in net amounting to 51 per cent.

Average Percentage Change, 1947-48, in Sales and Net Income of 185 Manufacturing Corporations Reporting Sales Decrease

Sales Decrease	Number of Companies	Average Change Sales	Average Change Net Income
1 to 10%	97	— 5%	—28%
11 to 20%	45	—15%	—49%
21 to 30%	26	—25%	—79%
Over 30%	17	—43%	—Def.
Total	185	—14%	—51%

These companies, widely scattered among the major branches of industry, had sales ranging from under $1 million to over $1 billion. The declines in sales and net income are computed as simple averages of all reports tabulated, in order to illustrate the typical experience, and are not weighted as to relative size of the different companies.



Average Percentage Change, 1947-48, in Sales and Net Income, of 185 Manufacturing Corporations Reporting Sales Decrease, Grouped by Size of Sales Decrease.

Of course, like all averages, the figures conceal wide individual fluctuations, due to such varying factors as ability to readjust costs promptly, inventory write-downs, etc. Thus a few companies were able to achieve gains in net notwithstanding lower sales, while others experienced shrinkages in net much greater than other companies with approximately the same sales experience.

On the whole, the pattern of sales and earnings is fairly clear, and while not conclusive as to what may be expected in all cases, is nevertheless broadly significant of the multiple impact of diminished volume on earnings, and of the difficulty of making cost adjustments promptly. The

rapidity with which earnings can melt away with shrinking volume suggests the danger of gauging industry's ability to absorb additional costs on the basis of earnings realized in periods of peak production and sales such as 1948. This is particularly true of costs that become rigid, such as increased wage rates, pension and welfare programs, carrying charges on new plants, and interest payments on expanded debt.

Investment of Corporate Funds

Year-end balance sheets now available for 150 of the larger manufacturing companies, each having sales or total assets over $5 million, show the continued heavy absorption of funds in current and fixed assets for meeting the record demand for products at advancing cost and price levels. The accompanying statement gives composite figures as of December 31, 1948, with comparisons for 1947, for end-of-war 1945, and for prewar 1940.

Composite Balance Sheet of 150 Manufacturing Companies with Sales or Total Assets over $5 Million
(In Millions of Dollars)

	December 31			
Assets	1940	1945	1947	1948
Cash	$ 524	$ 785	$ 846	$ 764
Government securities†	56	602	436	625
Receivables, net	436	784	1,006	1,000
Inventories*	1,093	1,784	2,563	2,857
Total current assets	2,109	3,855	4,851	5,246
Land, plant and equipment	2,746	3,147	4,197	4,774
Less depreciation	1,325	1,884	2,078	2,228
Net property	1,421	1,263	2,119	2,546
Other assets	408	343	366	364
Total assets	3,938	5,461	7,336	8,156
Liabilities & Capital				
Notes payable	52	178	199	218
A/c pay., accruals, etc.*	302	545	703	749
Reserve for taxes†	213	672	637	708
Total current liabilities	567	1,390	1,539	1,665
Bonds, notes, etc.	369	306	1,099	1,231
Reserves	51	95	111	118
Capital and surplus	2,951	3,670	4,587	5,142
Total	3,938	5,461	7,336	8,156
Working capital	1,542	2,465	3,312	3,581
Ratios:				
Current assets to current liab.	3.7	2.8	3.2	3.2
Equity capital to total liab.	3.2	2.2	1.7	1.8

†Before deducting tax notes offset against taxes payable.
*Includes advances on government contracts.

These companies, whose 1948 sales approximated $12.5 billion, had total assets of $8.2 billion at the year end. Of the funds invested to increase assets last year, $294 million was for carrying larger inventories at higher prices. Accounts and notes receivable were unchanged, while cash was lower and government securities were higher.

The largest investment of funds was for additions amounting to $577 million to gross plant and equipment. This heavy outlay for new and improved facilities in the petroleum, chemical, steel, machinery, automobile, food and other industries was a major factor in meeting the unprecedented deferred demands on the part of the public.

After deducting accrued reserves for depreciation, the net valuation at which the total property, much of it acquired years ago at lower costs, is carried on the balance sheet represents a great understatement in the light of actual present-day values and replacement costs. For this reason, many corporation executives and accountants have urged that, if the industries are properly to maintain their productive capacity and to finance long-term growth and improvements, they should be permitted by the Treasury Department to set up extra depreciation charges, deductible for income tax purposes, that would more nearly match current replacement costs.

This group of companies had an increase last year in total current liabilities and in net working capital, with the "current ratio" unchanged. There was a substantial increase in long-term liability on bonds, notes, term-loans, etc. The largest supply of new money, however, was from the increase in capital and surplus funds from the year's earnings, about 53 per cent of which was not paid out in dividends but was immediately reinvested in meeting the current demands of business.

One of the reasons the companies had to retain such a large proportion of earnings was the difficulty of raising new equity capital from outside sources. Even with this heavy plow-back of earnings, the ratio of equity capital to total liabilities was lower than in 1940 or 1945. In the absence of an adequate supply of outside money on a reasonable basis, it is only through large "retained" earnings that industry is able to finance soundly the costly replacements and improvements that are necessary to maintain and expand plant and equipment at the higher prices now prevailing.

Bank Reserve Requirements Again

Testifying before the Congressional Joint Committee on the Economic Report, February 14, Chairman McCabe of the Federal Reserve Board laid out the case in favor of the proposed extensions of Reserve Board powers over consumer credit and bank credit. This was the first item in the President's eight-point program of legislation to combat inflationary pressures, put before Congress January 5 in the "State of the Union" message.

In his testimony, Mr. McCabe first reported on uncertainties in the business situation as he saw them after a recent trip around the country, and dealt briefly with measures which the Federal

Reserve authorities could undertake, if necessary, to combat *deflationary* forces. He opened his discussion of the current proposals by quoting relevant passages from the President's Economic Report:

> On previous occasions I have recommended that adequate means be provided in order that monetary authorities may at all times be in a position to carry out their traditional function of exerting effective restraint upon excessive credit expansion in an inflationary period and conversely of easing credit conditions in a time of deflationary pressures.
>
> The temporary authority to increase reserve requirements of member banks of the Federal Reserve System, granted by the Congress last August, will expire on June 30, 1949. The expiration of this authority without further action of the Congress would automatically release a substantial volume of bank reserves irrespective of credit needs at the time.
>
> The Congress should promptly provide continuing authority to the Board of Governors of the Federal Reserve System to require banks to hold supplemental reserves up to the limits requested last August, 10 per cent against demand deposits and 4 per cent against time deposits.
>
> This authority to the Board of Governors should not be confined to member banks of the Federal Reserve System but should be applicable to all banks insured by the Federal Deposit Insurance Corporation.
>
> Authority for the regulation of consumer installment credit, which likewise expires under present law on June 30, 1949, should be continued in order to exert a stabilizing influence on the economy.

The proposed new powers Mr. McCabe presented as "a form of insurance" against the possible renewal of inflationary pressures. He reviewed familiar facts of wartime finance with the resultant near-tripling of the money supply (currency plus bank deposits), the inflation of prices and of the "gross national product." Taking note of recent price drops, slackened bank lending, reduced nonbank investors' sales of government bonds to the Federal Reserve, and a "small" decline in bank deposits last year, Mr. McCabe admitted the possibility that postwar inflation may have run its course. But this, he emphasized, is by no means certain. "The existing and potential money supply could still generate strong inflationary pressures."

What are these potentials? Mr. McCabe mentioned three in various parts of his testimony. For one, nonbank holdings of government securities, "which can be readily converted into money," run to $130 billion. Second, commercial banks hold over $60 billion of marketable government securities "which they could convert at will into reserves capable of supporting an enormous deposit expansion." Third, "the turnover of bank deposits is currently much less than it has been in many previous periods of high economic activity, and spending for all purposes could be considerably expanded without any further increase in the amount of the outstanding money supply."

The Stumbling Block

Mr. McCabe disclaimed that the proposed supplemental reserve requirement is "the perfect or final solution of the problem of arming the monetary authorities with adequate means of performing their primary function." The stumbling block is the policy of stabilizing the government bond market. This policy Mr. McCabe wholeheartedly endorsed, while realizing that it "limits the System's ability to restrain credit expansion." He put the case for the additional authority more or less on the grounds of a stop-gap. "It would not be used to force banks to liquidate outstanding loans." It would be used only to absorb future additions to reserves from (1) imports of gold; (2) return of currency from circulation; and (3) purchases of government bonds by the Federal Reserve Banks.

Mr. McCabe placed the magnitudes of these three items, for the year ended last October, at $2 billion for gold and currency combined, and $10 billion for Federal Reserve purchases of bonds which, he indicated, came "largely from nonbank investors." Thus it is quite evident how heavily the bond price-pegging policy weighs in the scales. The fact that the money supply did not increase by $12 billion during the year ended October, but rather showed very little change, is explained (1) by the use of surplus Treasury revenues to pay off bank-held and Federal Reserve-held debt, and (2) by the sales of short-term government securities which the Federal Reserve Banks have been able to make since the Fall of 1947 when the rates on these securities were "unfrozen" from the very low levels reached during the depression and maintained during the war and early postwar years.

At the conclusion of Mr. McCabe's testimony, Edward E. Brown of Chicago, President of the Federal Advisory Council, who was present at the hearings, indicated that the Advisory Council (the statutory body appointed by the directors of the 12 Federal Reserve Banks to advise with the Reserve Board) had opposing views which they would be prepared to set forth at an appropriate time.

It is to be hoped that the proposals this time will lead to a more thorough public discussion than was possible at the short session last August when the Congress granted the Federal Reserve Board, for a trial period, powers to impose peacetime consumer credit controls and to raise member bank reserves requirements above the ceilings set in the Banking Act of 1935.

The Background

The Federal Reserve Board has periodically pressed the Congress for additional powers since its Annual Report of 1945 laid out proposals for requiring banks to hold stated "secondary reserves" of short-term Treasury paper, and raising regular reserve requirements.

In November 1947, when Congress met to authorize European aid and to consider anti-inflation measures recommended by the President, Chairman Eccles, on behalf of the Reserve Board, set out a plan for "special reserves" — a modified version of the "secondary reserve" (or "certificate reserve") proposal.

Last Spring, when the Congressional Joint Committee had four or five days of hearings on credit control and the bond price-pegging policy, Governor Eccles asked for authority to add 10 points to basic reserve requirements on demand deposits and 4 points on time deposits, with the "special reserve" project, involving 25 and 10 points respectively, to be loaded on besides when, as and if needed. Under this combination, reserve requirements on demand deposits, which ran 7, 10 or 13 per cent (depending on the reserve classification of a bank) prior to 1936, and are scaled 16 — 22 — 26 per cent under current law and regulations, could be put as high as 49 — 55 — 61 per cent, partly to be satisfied by holdings of short-term governments. Reserve requirements on time deposits, formerly 3 per cent and now 7½ per cent, could be put as high as 20 per cent. Any such increases could of course greatly curtail the lending and earning power of the banks. Other representatives of the Reserve System presented to the Committee a tentative scheme for a complete recasting of the method of fixing bank reserves.

The "ten and four" supplement to basic reserve requirements was again proposed to Congress, in the special session of Congress last August with the important difference that this time it came with the full backing of the Administration. Reflecting some doubts as to the efficacy of this approach to credit control, especially in light of the bond price-pegging policy, the Congress granted a temporary authority to the Federal Reserve Board to raise legal reserve requirements four percentage points (instead of ten as proposed) above the regular statutory limit on demand deposits and one and one-half points (instead of four) on time deposits. This authority, which expires June 30, was called into use in September to the extent of two points on demand deposits and to the full extent of one and one-half points on time deposits.

What is now proposed, in substance, is what was proposed to the special session of Congress last August, except that the "supplemental reserves" this time would apply to all the 13,600 banks insured by the Federal Deposit Insurance Corporation (which includes the 6,900 member banks of the Federal Reserve System) rather than to simply the Federal Reserve members. The new power would not apply to uninsured banks, which number around 1,000, nor of course to thousands of other credit-granting institutions which are not classified as "banks". The effort to include State nonmember banks will raise the issue of "States rights" and greatly increase the resistance. Used to its limit, the new power would force the banks affected to put on the market around $10 billion of the government securities they presently hold.

The Question of Timeliness

One immediate question that the proposal raises is that of timeliness. As indicated on earlier pages of this Letter, there are abundant signs of a deterioration in the economic situation. Mr. McCabe freely admits their existence but points out that "no one can be sure that inflationary dangers are over rather than merely interrupted." This is true. But it is also true that every threat of action to deal drastically with inflation, as though that were an immediately pressing problem, is disturbing and increases the danger of deflation.

Real Causes of Inflation

A second question which should be reviewed in the thorough hearings which are to be anticipated on this question is whether the real causes of inflationary tendencies have been and are likely to be in the area of bank credit. It is our belief that any careful examination will show that for a number of months past bank credit has been granted and used by business with great conservatism, and that the real causes of the inflation we have had are to be found in quite other areas, and particularly in the spending policies of the Government itself.

Members of the Federal Reserve Board have been courageous in pointing out some of the inflationary policies of the Government. In Congressional hearings last year, for example, Governor Eccles referred to easy mortgage credit, government-sponsored, as "one of the most inflationary factors in the domestic credit picture." He urged cutbacks in public works, and more generally the postponement of every government expenditure "that it is possible to postpone." He also recognized the hampering effect of the tax structure on the equity capital market which in

turn has swollen the borrowing requirements of business. If the Government through its spending and other policies should restimulate inflation the proposed pressure on bank credit would be "spitting against the wind."

A Clash of Purpose?

In the President's Economic Report, to which Mr. McCabe referred, great stress is placed upon "the maintenance of stability in the Government bond market":

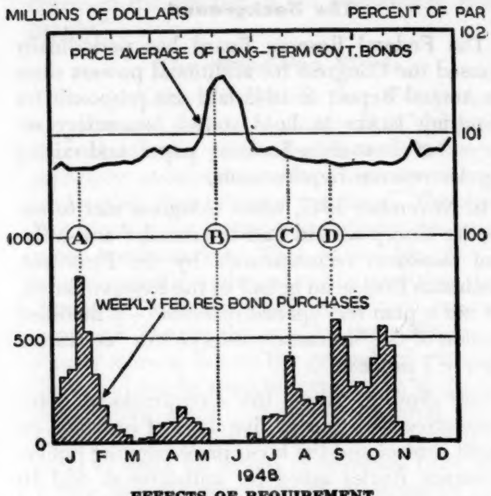
> Such stability in the Government bond market has been a most significant element in the smooth reconversion from a wartime economy to a civilian peacetime economy. It contributes to the underlying strength of the financial structure of the country. It engenders business confidence. It has made it easier for business and industry to obtain the capital funds necessary for their reconversion and expansion projects.

One major question that should be raised is the relation between this aim and changes in bank reserves. How do increases in bank reserve requirements fit in with stability in the bond market?

For the evidence on this subject one need go back no further than last year. The accompanying chart shows how actions on reserve requirements during 1948 were reflected in price fluctuations of long-term Treasury bonds and in Federal Reserve purchases of Treasury bonds (most of which were long-terms) in the price-pegging operations. Each of the first two reserve requirement increases, announced January 23 and June 1 respectively, was ordered under pre-existing authority and covered only the New York and Chicago banks. Each order tacked 2 additional points on reserve requirement percentages for demand deposits and required the banks affected to raise around $500 million in additional cash. The only way they could do this was to sell government securities.

The action of January came at a time when bond liquidation was already under way, and prices were already down on the "pegs." Here the effect of the action was recorded in Federal Reserve price-supporting purchases which quickly doubled in volume. Federal agencies and trust funds also were drawn upon to meet the accelerated tide of investor selling.

The June action came at a time when bond prices had rallied up off the pegs, the market had regained an equilibrium, and Federal Reserve price supports were no longer necessary. In this case the sequel was a decline in bond prices which continued until the authorities were again having to buy up bonds to support their prices.



EFFECTS OF REQUIREMENT INCREASES ON THE BOND MARKET

A. Increased reserves in N. Y. & Chicago ordered (Jan. 23)
B. Second increase in N. Y. & Chicago ordered (June 1)
C. Legislation for new powers prepared (1st week of August)
D. Increased reserves for all member banks ordered (Sept. 8)

Bond price average is that for fully taxable issues due or callable in 15 years or over.

Federal Reserve bond purchases are based on reported increases in total holdings of U. S. Government bonds. Sales, made on a minor scale in a few weeks, are not shown.

The September Experience

Uneasiness in the market was aggravated the first of August, when it became evident that the Congress would grant new authority to raise bank reserve requirements, as proposed by the President. The Federal Reserve had to meet a fresh burst of selling and official price-supporting operations carried all the way into November. The increases in required reserve percentages under the new authority, ordered September 8, affected all the member banks and compelled them to raise $2 billion additional cash to hold on deposit with the Reserve Banks. The action was followed by the heaviest selling of the entire year as bank sales were contagious and made nonbank holders of governments uneasy. The amount of bonds the authorities bought in, during August, September, and October, exceeded $4 billion. Three quarters of these bonds came out of the portfolios of nonbank investors.

The experience also showed that the raising of reserve requirements was not only self-defeating but unnecessary. For when new reserves came into the banks as a result of Federal Reserve bond buying from nonbank sellers, there was no piling up of excess reserves nor any "multiple expansion" of credit, as is so often claimed. The banks almost automatically used any new reserves to buy government securities which the Federal Reserve released.

It is of course true that, within some indefinable limits, the Federal Reserve authorities can order increases in reserve requirements and then buy up bonds in whatever quantities are required once again to restore confidence among holders. But the question comes up as to what is gained by disturbing confidence and then setting about to restore it, slowly and laboriously, and at the cost of vast additions to an already inflated Federal Reserve bond account — additions which themselves may be a source of uneasiness not only to all holders of bonds but to citizens concerned with the inflationary implications of loading down a central banking system with so much long-term government paper. There have been strong enough forces, over the past eighteen months, pressing government bond prices down against the pegs, without the use of new powers to aggravate selling pressure and to provide sterner tests of official determination and capacity to hold the line.

The 1948 experience, of severe repercussions on the bond market from reserve requirement increases, was nothing new. In 1937 sharp advances in the requirement percentages precipitated liquidation of government securities on a scale that knocked government bond prices down four to six points in two months time and led the Reserve authorities finally to come to the support of the market and thereafter to give greater consideration to the effects of their actions on the bond market. The Annual Report of the Federal Reserve Board for 1937 concluded its discussion of the experience with the following observations:

> In recent years the bond market has become a much more important segment of the open money market, and banks, particularly money-market banks, to an increasing extent use their bond portfolios as a means of adjusting their cash position to meet demands made upon them. At times when the demands increase they tend to reduce their bond portfolios and at times when surplus funds are large they are likely to expand them. Since prices of long-term bonds are subject to wider fluctuations than those of short-term obligations, the increased importance of bonds as a medium of investment for idle bank funds makes the maintenance of stable conditions in the bond market an important concern of banking administration.

All of the above indicates that there is no way of shutting off the banks and the bond market in two separate airtight compartments. Any action on bank reserves immediately affects the government bond market and vice versa.

Chairman McCabe's testimony if analyzed reveals clearly the dilemma of the central banking system — it is simply impossible to tighten credit generally without tightening the bond market. To stabilize the bond market by buying all offerings at pegged prices makes money cheap. As Mr. McCabe says, the banks hold $60 billion of marketable government securities and nonbank holders another $130 billion, marketable or redeemable. As long as the Reserve System stands ready to turn them into cash, credit will be relatively easy. To try to beat the devil around the bush by legislation on bank reserves is unavailing.

The Reserve System now holds $22 billion of government securities. The power to press these securities on the market, or to buy additional ones in the market, to raise or lower money rates, constitutes the power of credit control. It is a huge power.

Current Situation

With the lessening of inflationary pressures the government bond market is now on its own feet, without official support, and the Federal Reserve authorities have been able to feed out $1 billion of the long-term bonds they accumulated during the enormous selling waves of last year. With their finger on the pulse of the bond market, as well as on the general credit picture and business developments, they are in a position flexibly to modify their policies as necessary from week to week, from day to day, or even from hour to hour. This sort of operation is less spectacular than lightning bolts out of the blue, in the shape of reserve requirement changes, but it is consistent, as reserve requirement changes are not, with the objectives of an orderly market. Day-to-day purchases or sales of government securities provide a principal and effective means for the Federal Reserve authorities to carry out, within the concept of an orderly market, what the President calls "their traditional function of exerting effective restraint upon excessive credit expansion in an inflationary period and conversely of easing credit conditions in a time of deflationary pressures."

If the inflationary trend is resumed the Reserve System and Treasury have enormous powers to influence the cost and volume of money through their management of the government security market. They will then face once more the dilemma of the relative responsibilities for a stable government security market or a stable national economy. The two are sometimes mutually inconsistent.

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